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SUBJECT: MALAYSIAN GOVERNMENT DECIDES PROTON WILL NOT SEEK A FOREIGN PARTNER: POLITICS TRUMPS ECONOMICS

¶1. (SBU) Summary: After nearly two years of back-and-forth negotiations with Volkswagen, the Malaysian government has decided that government-controlled auto maker Proton would no longer pursue a strategic partnership with the German auto manufacturer or any other foreign partner (including General Motors, with which it had also held discussions). Rather than look to a foreign partner to help revive the perennial loss-maker, the government announced that the firm was doing well and should be given a chance to turn around. Its auto sales were expected to more than double in Asia, particularly for its new models. Industry experts claim the government backed off the idea of Proton taking on an international partner because hundreds of local vendors would be unlikely to survive the kinds of reforms a world-class partner would demand. Many of these vendors are owned by ethnic Malays who enjoy protected status in multicultural Malaysia. Taking action to force Proton to reform therefore would be unpalatable to part of the government's key Malay constituency, a particular concern to UMNO now with a national election on the horizon. End summary.

¶2. (U) The Malaysian Cabinet has decided that national automaker Proton would no longer pursue a foreign partner. In announcing the decision on November 20, Finance Minister (II) Nor Mohamed Yackop said that recent signs of a financial turnaround by Proton had convinced the government that Proton could prosper without a foreign partner. These signs included stronger than expected orders for Proton's new Persona model. The announcement came as a surprise to most analysts, given reports that Proton was in the final stages of negotiations with Volkswagen which would have allowed the German automaker an equity (though likely not controlling) stake in Proton. (General Motors reportedly was also still in the running as an alternative to VW). Malaysian Automotive Association (MAA) President Aishah Ahmad publicly voiced doubts about the durability and depth of Proton's supposed turnaround, noting that a partnership with a foreign manufacturer would have been good for Proton's branding, and that Proton still needs to develop a sustainable, long term strategy to reverse its years-long slide from dominating the Malaysian market.

SMOKE AND MIRROR PROFITS

¶3. (U) Boosted by the sale of land and the wrap-up of some project development costs, Proton posted a million-dollar profit for its

second quarter ending September 30, compared to USD 75 million in losses in Q2 last year in a long succession of multi-million dollar losses. Revenue was up 3% over second quarter figures last year due to a 1.3% increase in auto sales. Although this growth was modest, Proton Chairman Mohammed Azlan Hashim pointed to it as an indication that Proton's sales would rise from their current levels of 30,000 to 40,000 units per model to between 100,000 and 150,000 units per model by 2011, primarily through greater exports to China, India, ASEAN, and to a lesser extent Iran.

HOPES PINNED ON NEW MODELS, ASIAN DEMAND

¶4. (U) Ministry of International Trade and Industry Minister Rafidah Aziz told the press that Proton had its own strategic plans to capture regional markets, especially in India, China and Southeast Asia. She said the American and European automotive markets were different and "not for us"; rather, the growth market is in Asia. Proton recently signed partnerships with the Governments of China and Thailand, including a deal to allow for the export of 30,000 Proton cars to China by the end of the year. At an auto show in Thailand this week, Proton unveiled its new fuel-efficient model, the Savvy, its new sportscar the Neo, and its re-designed Gen.2, all of which Proton expects will help improve its sales in Asia. As recently as July Rafidah had told the press that the government was interested in selling its 43 percent stake in Proton that it holds through government investment arm Khazanah (the government indirectly controls additional shares of Proton, including 12 percent through the Employee Provident Fund and 8.8 percent through national petroleum corporation Petronas).

BUT QUALITY AND COMPETITIVENESS A PROBLEM

¶5. (U) At a recent panel discussion on Creating Global Champions Mr. Rameli bin Musa, Executive Vice Chairman for Ingress Corporation, a tier one vendor for Proton, said that a lot of vendors depended on Proton. He described some of the challenges Ingress faced when the company began supplying auto parts for Honda and Toyota, including much tougher quality standards. Another panelist, Mr. Yong Poh Kon, President of the Federation of Malaysian Manufacturers, elaborated on this point, explaining that where Proton capped defective parts at 200 parts per million, Honda demanded no more than six per million, and Toyota ten per million. This level of quality was one reason Malaysian auto parts suppliers were reluctant to venture beyond Proton for business, he said.

¶6. (U) Also at the conference, Akifumi Kuchiki, Executive Vice President of Japan External Trade Organization (JETRO) pointed out that Thailand quickly was becoming the "Detroit of Asia" and that Malaysia was being left behind. He suggested that Malaysia could focus on exporting automatic compact cars, while firms in Indonesia and Thailand could engage more in exporting pickup trucks and multipurpose vehicles, respectively. He said some of the constraints facing the Malaysian auto industry included an insufficient supply of unskilled labor, a need to upgrade the skills of its skilled labor, and an inadequate supply of quality parts manufacturers. Malaysia also needed to liberalize and deregulate national auto policies if it wanted to attract foreign firms in the support industries.

COMMENT:

¶7. (SBU) Comment: The Malaysian Cabinet's decision to prohibit Proton from taking a foreign partner surprised most industry watchers, likely including Proton itself, which had appeared on the cusp of signing a deal with VW. With the government focused on upcoming elections, however, politics trumped economic rationality. Although long a supporter of Proton's efforts to seek a foreign partner, the government decided in the end that it was not yet ready to permit a fundamental shift away from a 20-year tenet of Malaysian industrialization - the promotion of a national car. Given the

political sensitivities surrounding both Proton and its pyramid of local suppliers, most of which are owned by ethnic Malays, only a foreign partner could have demanded the kinds of reforms necessary to make the company competitive. Unfortunately, as long as the government continues to subsidize Proton's losses, neither the national automaker nor its vendors will have the incentive to become globally competitive. In the case of Proton, the GOM's unwillingness to upset its spoils system has once again undercut its efforts to rationalize the economy.

KEITH